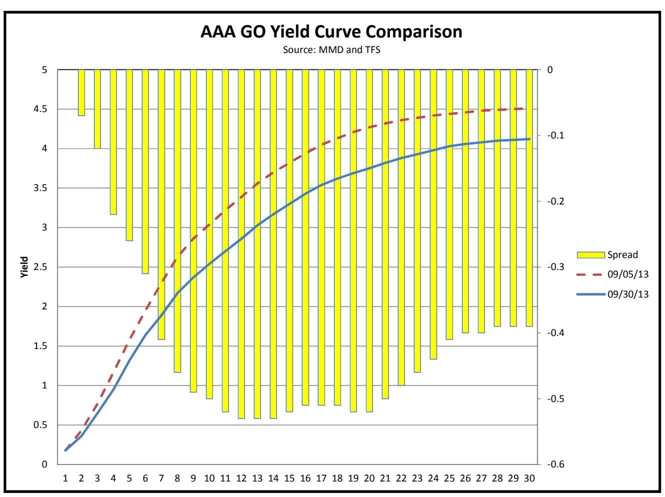
TEMPLETON FINANCIAL SERVICES

Credit Comments
October 2013

Review: Bonds Do Better As The Fed Keeps Buying

After sending the market lower in May, the bond market reversed course when the Fed announced they would not reduce their asset purchases in September as expected. Fed members were concerned the economy had not shown enough strength to warrant a slow down in purchases of US Treasury and Mortgage securities. This sent a signal to the bond markets that the economy was weaker than expected, and that rates will continue to be low for a longer period of time than recently expected. The market quickly rallied on the news. The chart below shows the movement in Munis for the period from 9/5/13 to 9/30/13. The yellow bars in the graph show the magnitude of the yield curve shift by maturity.

Muni Index	Duration	Return For September	Return For 3Q 2013
ML Municipal 3-7 Yr Index	4.05	1.05%	0.91%
ML Municipal 12-22 Yr Index	9.10	2.89%	-0.39%
Taxable Index	**Duration**	**Return For September**	**Return For 3Q 2013**
ML U.S. Corp & Govt 5-7 Yr A Rated and Above	5.54	1.40%	0.76%
ML U.S. Treasuries/Agencies 7-10 Yrs	7.58	1.53%	0.03%
ML U.S. High Yield BB-B Rated	4.70	1.00%	2.08%



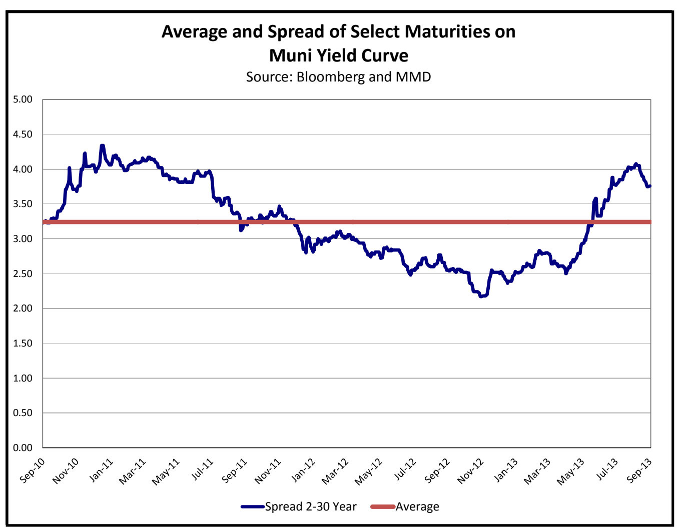
The 10 to 15 year part of the curve rallied about 50 bp's.

Bond Fund Selling Slows

There are some signs that Muni bond fund outflows might be slowing. Since March of this year there has been a total of $48 billion of Muni mutual fund outflows. Recently, however, selling has slowed to a trickle. High yield Muni funds have actually seen inflows during the last 2 weeks. We expect this trend to continue as investor fears of rising rates are dampened by continued Fed purchases of bonds, a relatively weak economy, a lack of inflationary pressures, and a potential economic slowdown caused by the governmental shutdown. Demographic trends are also favorable for bonds as many in the baby boomer generation will need to increase their retirement income. Tax-free yields over 5.00% are still currently available in 15-20 year maturities for investment grade securities. These are historically attractive yields for income oriented retail investors with taxable equivalent yields (TEY) of 8.00-8.50%.

Steepness In The Yield Curve Helps Support Munis

The chart below shows the steepness of the yield curve by measuring the yield spread between 2 and 20 years. Over the years there has been good support for the market when this spread is around 400 bp's. The Fed's zero interest rate policy combined with investor fears of higher interest rates has caused the curve to steepen from a little over 200 bp's to as much as 400 bp's during the last year. We feel the steepness of the curve will lend support to the market as investors are encouraged to move out the curve to pick up more yield.



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Risks of Quantitative Easing (QE)

Paul Mortimer-Lee from BNP Paribas wrote an interesting paper in May 2012 entitled "The Effects and Risks of Quantitative Easing" which was published in the *Journal of Risk Management in Financial Institutions.* He notes that QE is an unconventional policy and is implemented when conventional policies don't work, because interest rates are already at zero. In this paper he argues there are 4 primary risks of QE. First, there is the risk that QE might not work. Recent papers done for the Fed suggest that the benefits of QE are diminishing. We believe the Fed is concerned about the effectiveness of QE, and would like to eventually taper their long term asset purchases.

Secondly, there is the chance that QE might spur inflation. While actually designed to fight deflation, an emphasis on asset purchases and balance sheet expansion might work too well, causing inflation expectations to become a destabilizing force in the economy.

Next, QE distorts the securities markets. This becomes a problem if investors avoid the market because they believe rates are artificially low. This can lead to issues with price discovery and liquidity in the markets. Eventually, the Fed might become the only buyer. This lack of liquidity increases price volatility and causes the market to become less efficient.

Finally, there are the risks associated with an exit from QE. Since the Fed has no experience unwinding QE, it seems likely they will have a difficult time judging when to exit and how to exit. Managing expectations will be of paramount importance. Recent violent interest rate swings surrounding the Fed's taper announcement show how difficult it is to manage expectations for a market that has become dependent on QE. For instance, the mere mention of tapering in May caused mortgage rates to rapidly shift from 3.25% to 4.625% for 30 year fixed rate financings. Markets are forward looking and will quickly reflect the full shift in policy even if there is only a small reduction in Fed purchases.

These types of violent market swings in a distorted market with diminished liquidity have raised investors fears significantly. It will be interesting to see how and when the Fed plans to end QE. Our concern is that QE is designed to work in a financial crisis, yet we are still using it 5 years after the crisis. One has to wonder what tools the Fed would have left to impact the economy in an economic downturn, when unconventional policies have become conventional.

With the markets preoccupied with tapering and ultimate exit from QE, we are becoming increasingly concerned that QE will become harder to unwind. If the Fed would abandon their efforts to manipulate long term interest rates, we believe the markets could establish where rates should be naturally. We expect they would not be much different than where they are right now.

Credit Issues

The high levels of debt and unfunded pension and OPEB liabilities have made credit valuation extremely important. Our strategy of avoiding large cities has worked well in this credit environment. Large cities frequently suffer from population declines, strong public unions, unfunded pension liabilities, and an inability to make difficult decisions regarding budget issues. Our strategy has allowed us to avoid the bankruptcies of Vallejo, Stockton, and Detroit. We have also avoided bonds issued by the Territory of Puerto Rico. While Puerto Rico is not in bankruptcy, it exhibits many of the same problems listed above and is experiencing extreme financial stress. Some Puerto Rico bonds traded as cheaply as 10.00% during the last month, before settling in the 8%-9% yield range. We prefer to invest in bonds with a strong public purpose, such as education, or bonds that have a dependable stream of revenue such as essential service revenue bonds. We have also been a buyer of hospital bonds with good credit metrics.

Conclusion

The recent rise in rates has given investors an opportunity to build up the income component of their portfolios. We believe income return will become an increasingly important part of the total return of fixed income portfolios. Rates currently available in the market have priced in less Fed involvement through QE. While it is difficult to know what the "fair value" of the 10 yr UST should be because of QE distortion, we have found value in taxable and tax- free bonds in the 10-15 year part of the curve. These bonds have been trading at higher yields than we have seen in the last 2 years, and are in many cases quite a bit cheaper than US Treasuries.

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